

# SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Haynes Analyst: LuAnna Hass Bill Number: SB 366

Related Bills: See Prior Analysis Telephone: 845-7478 Amended Date: June 4, 2001

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Taxpayer Bill of Rights/No Levy May be Made on Principal Residence of Innocent Partner/Release of Certain State Tax Liens

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended May 1, 2001.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED May 1, 2001, STILL APPLIES.

OTHER - See comments below.

## SUMMARY

Under this bill, the Franchise Tax Board (FTB) would be:

- prohibited from seizing and selling (levying) a principal residence of an innocent partner if the reason for the levy is the fraudulent action of another partner.
- required to release any state tax liens on or the proceeds from the sale of the principal residence of an innocent partner if the innocence of the owner is substantiated.

## SUMMARY OF AMENDMENTS

The June 4, 2001, amendments removed the provisions that would have prohibited FTB from:

- extending any state tax lien beyond the authorized ten-year period.
- allowing a state tax lien to attach to a taxpayer's property that qualifies as a "declared homestead."

Except for a new revenue analysis, the remainder of the department's analysis of the bill as amended May 1, 2001, still applies. The June 4, 2001, amendments resolved several, but not all, of the department's implementation and policy considerations discussed in the department's analysis of the bill as amended May 1, 2001. The remaining implementation and policy considerations have been included below.

Board Position:

<u>      </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> OUA	<u>      </u> X PENDING

Legislative Director

Date

Brian Putler

06/21/01

## POSITION

Pending.

### Summary of Suggested Amendments

At the author's request, amendments are provided to address the department's implementation concerns and selected policy concerns.

## IMPLEMENTATION CONSIDERATIONS

Staff has identified several implementation considerations. The attached amendments would resolve these concerns, as discussed with the author's office.

1. According to the author's office, this bill is intended to protect individuals like those characterized in various newspaper articles as investors in partnerships promoted by Walter J. Hoyt, III. As detailed under "Program Background" in the analysis of the bill as amended May 1, 2001, Hoyt was convicted of various criminal acts involving fraudulent activity. However, the criminal acts that were not classified as fraud may have been the actions that resulted in the investor's tax adjustments and underpayment. Therefore, this bill may not grant these investors the relief intended by the author. The attached Amendment 1 redefines the "innocent" person in relationship to investors in abusive tax shelters, which was the case of the "Hoyt" investors.
2. As amended, the bill would require the department to release liens on proceeds from the sale of an innocent partner's principal residence in escrow. An escrow period, which typically lasts 30-60 days, may not be sufficient time for FTB to determine whether the taxpayer is "innocent." Amendment 1 would require FTB to release the proceeds if the taxpayer substantiates that they are an innocent investor and if the basis for that levy is the underpayment of any tax attributable to an abusive tax shelter.
3. The definition of "innocent partner" hinges on two elements: a partner who (1) did not engage in fraudulent acts, and (2) was not aware of any fraudulent acts. A determination of a partner's innocence would be highly subjective. The taxpayer claiming innocent partner status would have to show that they were not aware of and did not engage in any fraudulent action that resulted in the underpayment of tax. It may be difficult to prove a negative proposition of this nature. In the *Hoyt* criminal case, the investors were not a part of the federal criminal litigation so there would be no legal findings of their "innocence." Amendment 1 would define an innocent investor as one who had no responsibility for the creation, promotion, operation, management, or control of the abusive tax shelter and who was merely an investor. In addition, to qualify as "innocent," the taxpayer would have not known that the entity, plan, or arrangement would be an abusive tax shelter.

4. The bill lists a "joint venture" as an entity in which a partner may be protected under this bill. A joint venture is only one of several entities that can be a partnership. Other entities that can be partnerships are syndicates, groups, pools, or other unincorporated organizations. To avoid confusion, Amendment 1 would remove the specific reference to "joint ventures" from the bill.
5. For liens on a principal residence to be released under this bill, the release is conditional on taxpayers establishing that they are innocent partners. However, the bill does not make it conditional that taxpayers establish innocence before FTB is prohibited from levying the taxpayer's principal residence. Amendment 1 would make the levy prohibition provision conditional on establishment of the "innocence" of the taxpayer.
6. The bill prohibits the levy on principal residences if the basis of the levy is a fraudulent act of another partner. However, the basis for a levy primarily is unpaid tax. Therefore, Amendment 1 clarifies that the basis for the levy in subdivision (a) would be the underpayment of any tax attributable to an abusive tax shelter.
7. Subdivision (c) of proposed new Section 21015.6 defines "innocent partner" in terms of a lien related to an underpayment of tax that is addressed in subdivision (b). The definition does not specifically apply to the levy provision in subdivision (a). Amendment 1 clarifies that the definition of "innocent investor" applies for purposes of both subdivisions.
8. A state tax lien recorded in the county where the principal residence is located would affect any real property transactions relating to that principal residence. The state tax lien only indirectly affects the escrow account. Amounts are disbursed to the department from the escrow account to satisfy, and for the title company to receive a release of, the state tax lien. Technically, a recorded state tax lien does not actually attach to nor would be released on escrow proceeds. Therefore, Amendment 1 would amend the bill to delete the reference under the lien provision to the escrow accounts and proceeds thereof, and would expressly require the FTB to release the lien on the principal residence without satisfaction of any portion of the property subject to the lien. However, in those rare instances where a notice of state tax lien has not been recorded by the time of a voluntary sale of real property, FTB could levy on the proceeds in escrow. Amendment 1 has provisions to require the release of such a levy and to require the return of any proceeds obtained through the levy.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in revenue losses as shown in the following table:

Estimated Revenue Impact of SB 366 As Amended 6/4/01 [\$ In Millions]			
	2001-02	2002-03	2003-04
Innocent Partners	negligible loss	-\$0.5	-\$0.5

Negligible loss is less than \$250,000

### Revenue Discussion

The revenue impact of this bill would be determined by the amount of foregone collections that would otherwise have resulted from state tax liens recorded on either an innocent partner's principal residence or escrow or other accounts holding proceeds from the sale of an innocent partner's principal residence.

Circumstances placing a taxpayer in the position of an innocent partner, as defined, would appear to be rather limited. However, the bill would eliminate a collection tool in these limited circumstances. When no other means of collection exists, a lien attaching to a principal residence secures the unresolved tax debt. In addition, a tax lien recorded before a bankruptcy petition is filed would survive a bankruptcy proceeding. Under these circumstances, a lien becomes the only means of securing a tax debt.

The department is currently holding pending final federal determination approximately 400 assessments issued to about 100 investors in partnerships who were California residents. Assessed taxes average approximately \$3,000 per tax year and four tax years per investor (total of \$12,000). Tax years at issue range from 1975 through 1994 with accrued interest increasing amounts due substantially. Each of these investors would fall into the innocent partner category of this bill.

If, in any given year, the total number of innocent partner liens for all relevant cases for which bankruptcy proceedings have been completed were 25, the amount of tax and interest potentially at risk would be around one-half million dollars (assuming an average balance due of \$25,000).

As discussed under "Policy Considerations," an amendment is being suggested to change the term "innocent partner" to "innocent investor." Substituting the term investor would extend the provisions of this bill to individuals who are shareholders in other entities such as S corporations that invest in abusive tax shelters. An innocent investor also could include beneficiaries or trustees that have participated in fraudulent tax evasion schemes that are packaged as legitimate trusts, although it is unlikely many of these investors would meet the "did not know" criteria suggested in the amendment. The IRS estimates the federal government is losing billions of dollars of tax revenue from these fraudulent tax evasion schemes that are packaged as legitimate trusts. The IRS further indicates that a large percentage of these elaborate tax schemes to conceal income and create false business expenses for investors have gravitated to Northern California. To the extent these investors would fall into the innocent investor category of this bill, foregone collections of tax revenue would increase significantly.

### **ARGUMENTS/POLICY CONCERNS**

Current laws and FTB practices, on a case-by-case basis, would provide tax relief to "Hoyt"-like taxpayers experiencing financial hardship and free their personal residence from levy and liens. Some may argue that current law and practice are sufficient to protect any of these "Hoyt" taxpayers who are truly "innocent partners."

Many taxpayers that are not investors in abusive tax shelter partnerships experience devastating financial hardships. The intent of this bill is to offer tax collection protections to these certain partners beyond those given to other similarly situated taxpayers.

This bill would allow proceeds from a sale of the principal residence, regardless of the amount of the proceeds, to escape a recorded state tax lien. This policy would be in conflict with the law that allows liens to be released only if the release will not endanger or jeopardize the collection of taxes.

This bill applies only to partners. There are individuals who invest in other types of entities such as S corporations that may be abusive tax shelters. These individuals would not receive the same tax collection protections. If the term "investors" were substituted for the term "partners" as discussed under "Implementation Considerations" and as shown in Amendment 1, this issue would be resolved.

There have been several recent efforts at the federal level to discourage corporations from investing in abusive tax shelters. These efforts have included regulatory action by the Treasury Department and the introduction of proposed federal legislation. While such legislation has not been enacted, this bill would move in the opposite direction by creating the possibility that taxpayers who invest in some of the most aggressive shelters may ultimately avoid paying the correct amount of tax.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 366  
As Amended June 4, 2001

AMENDMENT 1

On page 4, modify lines 1 through 20, inclusive, as follows:

21015.6. (a)(1) No levy may be made on the principal residence of any innocent partner investor or the proceeds from the sale or other transaction involving the principal residence of an innocent investor if upon substantiation of both of the following:

(A) ~~the~~The basis for that levy is an ~~the fraudulent action of another partner~~ underpayment of any tax imposed under Part 10 that is attributable to an abusive tax shelter.

(B) The principal residence is owned by an innocent investor.

(2) If, prior to the transmission of amounts in compliance with a levy on the proceeds from the sale or other transaction involving a principal residence described in paragraph (1), the owner of the principal residence has notified the Franchise Tax Board that the principal residence is owned by an innocent investor, amounts received pursuant to that levy shall be returned to the owner of the principal residence upon substantiation specified in paragraph (1).

(b)(1) Any state tax lien recorded ~~, as described~~ under Chapter 14 (commencing with Section 7150), ~~or Chapter 14.5 (commencing with Section 7220)~~ of Division 7 of Title 1 of the Government Code, including a state tax lien described under Title 11, Section 522(c)(2)(B) of the United States Code, relating to state tax liens after bankruptcy, on the principal residence of an innocent partner investor or on an escrow or other account in which the proceeds from the sale of an innocent partner's principal residence are held, shall be released without satisfaction of the lien upon substantiation of both of the following:

(A) The ~~that~~ underpayment of tax of an innocent investor is the basis for the lien.

(B) ~~the~~The owner of that principal residence is an innocent partner investor.

(2) If, prior to satisfaction of a state tax lien described in paragraph (1), the owner of the principal residence subject to that lien has notified the Franchise Tax Board that the principal residence is owned by an innocent investor, amounts received pursuant to that state tax lien shall be returned to the owner of the principal residence upon substantiation specified in paragraph (1).

(c) For purposes of this section:

(1) "Abusive tax shelter" must satisfy both of the following requirements:

(A) Be a potentially abusive tax shelter within the meaning of Section 6112 of the Internal Revenue Code.

(B) With respect to which either of the following has occurred:

(i) The Internal Revenue Service has imposed a penalty under Section 6700 or 6701 of the Internal Revenue Code, or

(ii) The Franchise Tax Board has imposed a penalty under Section 19177 or 19178.

(2) an "Innocent partner investor" means any individual (or the spouse or former spouse of that individual) that satisfies each of the following requirements:

partner or a spouse or former spouse of any partner

(A) Acquired an interest in a partnership, limited partnership, or joint venture who did not engage in any fraudulent action an abusive tax shelter prior to the date the Internal Revenue Service or the Franchise Tax Board imposed a penalty described in subparagraph (B) of paragraph (1).

(B) Is liable for that resulted in the an underpayment of any tax imposed under Part 10 which is attributable to ownership of an interest in an abusive tax shelter.

(C) to which the lien Had no responsibility for the creation, promotion, operation, management, or control of the abusive tax shelter.

(D) During the tax years to which the underpayment described in subparagraph (B) relates, did not know that the entity, plan, or arrangement would be an abusive tax shelter was not aware of any fraudulent action, that resulted in the underpayment of any tax to which the lien relates.

(3) "Principal residence" includes any property that qualifies as a declared homestead as defined in Section 704.910 of the Code of Civil Procedures.

(d) Notification required by subdivisions (a) and (b) of this section shall be made at the time and in the manner prescribed in forms and instructions of the Franchise Tax Board.